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No. 84-1447 (H)

In the Supreme Court of the United States

OCTOBER TERM, 1985

WILLIAM Z. SALCER, ET AL., PETITIONERS

v.

ENVICON EQUITIES CORP., ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

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QUESTION PRESENTED

Whether defendants in a federal securities fraud action are entitled to reduce the amount of recoverable damages by tax benefits allegedly obtained by plaintiffs on account of their investment.

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This brief is filed in response to the Court's order inviting the Solicitor General to express the views of the United States.

STATEMENT

1. Petitioners are purchasers of interests in a real estate limited partnership, marketed as a tax shelter, to construct, own, and operate a multifamily rental housing project outside Houston, Texas (Pet. App. 3a). Respondents are the general partners of the project and their affiliates, lawyers and accountants (*ibid.*). Petitioners purchased their limited partnership interests in 1977-1978. In 1981, petitioners were forced to sell their interests to one of the respondents at a substantial loss (*id.* at 3a-4a).

In August 1982, petitioners brought this action in the United States District Court for the Southern District of New York, alleging violations of the antifraud provisions of Section 10(b) of the Securities Exchange Act of

1934 (the Act), 15 U.S.C. 78j(b), and SEC Rule 10b-5, 17 C.F.R. 240.10b-5. Petitioners contended that respondents had defrauded them by failing to disclose the City of Houston's intention to annex the property. They claimed that respondents should have anticipated at the time of the offering that annexation would result in more stringent building code requirements, causing significant delays, increased costs, and loss of financing. Petitioners sought rescissionary damages of $47,500 per partnership unit, a figure that represented the difference between the price petitioners paid ($77,500 per unit) and the amount they received in the forced sale ($30,000 per unit). Pet. App. 4a. Petitioners also requested prejudgment interest.

Respondents in their answer to the complaint asserted, by way of affirmative defense, that petitioners had suffered no cognizable damages because they had realized during their 1977-1981 tax years tax benefits stemming from their limited partnership investments in excess of their claimed per-unit loss of $47,500 (Pet. App. 4a). Respondents based this assertion on the limited partnership offering materials and on the assumption that each petitioner was taxed at a marginal federal income tax rate of at least 50% during the relevant years (*id.* at 4a-5a, 32a-35a). The calculation of petitioners' alleged tax benefits was made by respondents based on their own estimates (Appellants' C.A. Br. 40). There has as yet been no discovery into the actual tax consequences of the investment for petitioners during 1977-1981 (Pet. App. 5a).[1]

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[1] For purposes of the district court's ruling on their motion to strike, petitioners stipulated that respondents had correctly determined that the tax benefits they had claimed exceeded their net investment in the partnership (Pet. App. 34a; C.A. App. 205a-206a; Appellees' C.A. Br. 12).

2. The district court granted petitioners' motion to strike the affirmative defense (Pet. App. 19a-22a, 25a-31a). The district court reasoned that petitioners' investment consisted of two components: the opportunity to obtain tax benefits and the investment in a capital resource (*id.* at 26a-27a). Because the allegations of fraud pertained only to the capital investment component, the district court held that petitioners' recovery should not be reduced by their return on the tax benefit aspect of their investment (*id.* at 28a-29a). The district court certified its decision for immediate appeal under 28 U.S.C. 1292(b).

The court of appeals reversed and remanded (Pet. App. 1a-18a). The court of appeals suggested that resolution of the tax offset issue was inappropriate on a motion to strike because "the law * * * is confused and unsettled * * * [and] further facts must be obtained" (*id.*at 8a), but it went on in any event to address the merits of the defense. Relying on the "actual damages" limitation of Section 28(a) of the Act, 15 U.S.C. 78bb(a), the court reasoned that petitioners' tax savings must be subtracted from their loss in calculating damages because those savings represent tangible economic benefits to them (Pet. App. 8a-10a). It was irrelevant in the court's view whether the investment could be separated into distinct tax and capital components: "[t]o the extent that [petitioners] invested in a tax shelter, all benefits they received from their investment, including tax benefits, would have to be deducted in calculating the rescissionary damages, if any, to which they would be entitled" (*id.* at 11a). The court rejected arguments that its tax offset rule improperly made the government the banker for fraudulent activity, conflicted with the collateral source doctrine, treated tax benefits that might ultimately prove illusory as real, and reduced the incentives for private actions under the antifraud provisions of the securities laws (*id.* at 11a-17a).

DISCUSSION

The court of appeals has erroneously decided a recurring issue of substantial importance to both the government and private parties, and its decision conflicts with decisions of another court of appeals. Review by this Court is therefore warranted.

1. As the court of appeals recognized (Pet. App. 8a), the law on the question presented is "confused and unsettled." The decision below conflicts with *Western Federal Corp.* v. *Erickson*, 739 F.2d 1439 (9th Cir. 1984), and *Burgess* v. *Premier Corp.*, 727 F.2d 826 (9th Cir. 1984). In *Burgess*, the plaintiffs, like petitioners here, sought rescissionary damages under the federal securities laws for fraud in connection with a tax shelter investment (*id.* at 830). The court held that "deduction of the tax benefits from damages is inappropriate" in these circumstances (*id.* at 837-838). The court reasoned that allowing defendants to offset plaintiffs' tax benefits "would place an unfair burden on taxpayers generally" by "leav[ing] the government [to] bear[ ] the cost of defendants' fraud" (*id.* at 838). Plaintiffs would not receive a double recovery, in the court's view, "because under the tax benefit rule, their prior tax benefits will be disallowed" (*ibid.*). In *Western Federal Corp.*, the court followed its decision in *Burgess* and "refus[ed] to reduce the judgment by the amount of tax benefits [plaintiffs] realized from their investment" (739 F.2d at 1444).

Two courts of appeals, by contrast, have held that tax benefits must be deducted from plaintiffs' damages in suits under the federal securities laws. In addition to its decision below, in which the court of appeals rejected the Ninth Circuit's reasoning in *Burgess* (Pet. App. 12a, 15a), the Second Circuit recently held in *Freschi* v. *Grand Coal Venture*, 767 F.2d 1041 (1985), petition for cert. pending, No. 85-377, that tax benefits must be

deducted where the plaintiff seeks out-of-pocket damages for securities fraud. In *Freschi*, the court of appeals concluded that its decision in the instant case was controlling, see 767 F.2d at 1043, 1051.[2] Similarly, the Eighth Circuit has recently held that tax benefits must be deducted from the damages recoverable by plaintiffs who have been defrauded in connection with the purchase of their tax shelter investment, noting that its decision is substantially in accord with the decision below. *Austin* v. *Loftsgaarden*, 768 F.2d 949, 952 (1985) (en banc), petition for cert. pending *sub nom. Randall* v. *Loftsgaarden*, No. 85-519.[3]

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[2] In opposing certiorari here, respondents principally contend (Br. in Opp. 5-10) that the decision below should not be reviewed because it arises on a motion to strike under Fed. R. Civ. P. 12(f). It is clear from *Freschi*, however, that the Second Circuit treats the decision below as having conclusively determined the substantive issue presented, *i.e.*, whether tax benefits should be offset in tax shelter securities fraud cases. Moreover, the relevant facts are not in dispute—the parties argued the tax offset issue on stipulated facts (see Pet. App. 34a)—and petitioners have made it clear that they will suffer a dismissal if the tax offset rule is applied (*id.* at 32a-33a). Under these circumstances, the case is ripe for review by this Court.

[3] Respondents (Br. in Opp. 12) and the courts of appeals here (Pet. App. 17a) and in *Loftsgaarden* (768 F.2d at 952 n.4, 955 n.11) erroneously distinguish *Burgess* v. *Premier Corp.*, *supra*, as a case of actual rescission rather than one involving rescissionary damages. In fact, the plaintiffs in *Burgess*, like petitioners here, had already sold their investment, and they sought, as petitioners seek here, rescissionary damages equal to the amount of their investment less what they received in the sale. See 727 F.2d at 830, 837. In any event, the distinction between "actual rescission" and "rescissionary damages" is wholly irrelevant to resolution of the legal issue presented.

2. a. The court of appeals' decision rests on an unduly narrow view of the concept of "actual damages" under Section 28(a) of the Act.[4] Consistent with the remedial and compensatory purposes of private actions under the federal securities laws (see, *e.g.*, *Herman & MacLean* v. *Huddleston*, 459 U.S. 375, 386-387 (1983)), Section 28(a) permits recovery under traditional principles for determining compensatory damages. The purpose of Section 28(a)'s limitation of a plaintiff's recovery to "actual damages" is simply to prevent duplicative recoveries by persons asserting both state and federal claims arising out of the same course of conduct, and to prohibit the award of punitive damages and damages for non-economic losses such as pain and suffering. See, *e.g.*, *Osofsky* v. *Zipf*, 645 F.2d 107, 111 (2d Cir. 1981); *deHass* v. *Empire Petroleum Co.*, 435 F.2d 1223, 1230 (10th Cir. 1970).

In calculating the amount of damages under Section 28(a), courts must be careful to avoid unjustly enriching defendants. The Act does not prohibit an award based on the defendant's profit rather than the plaintiff's loss. To the contrary, adopting a measure of damages that will prevent defendants from retaining their ill-gotten gains is fully consistent with the purposes of the securities laws. See, *e.g.*, *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 155 (1972); *Hackbart* v. *Holmes*, 675 F.2d 1114, 1122 (10th Cir. 1982). While we disagree with the court of appeals that plaintiffs would receive "an undeserved windfall" (Pet. App. 13a) absent the offset of tax benefits—because, as we explain

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[4] Section 28(a), 15 U.S.C. 78bb(a), provides in pertinent part:

> [N]o person permitted to maintain a suit under the provisions of this chapter shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of. * * *

below, any apparent windfall will often prove wholly illusory in view of the tax consequences of the damage award—it is in any event clear that Section 28(a) "does not foreclose a windfall recovery based on the defendant's benefit rather than the plaintiff's loss." L. Loss, *Fundamentals of Securities Regulation* 1134 (1983).

Nor is there any unfairness in a measure of damages based on the defendant's benefit rather than the plaintiff's loss. In the first place, as between the innocent plaintiff and the defendant who defrauded him, the former is quite plainly more equitably situated to retain in the first instance any tax savings obtained as a result of his investment. If there is to be a windfall, surely it should rest in these circumstances with the plaintiff and not with the defendant. Indeed, any net tax savings retained by a plaintiff may compensate him for the loss of the use of the funds fraudulently obtained by the defendant, much as would an award of prejudgment interest (see *Burgess*, 727 F.2d at 838; SEC C.A. Br. 15-16). Finally, measuring damages without offsetting tax benefits is consistent with the long-recognized "collateral source" rule, which provides that "benefits conferred on the injured party from other sources are not credited against the tortfeasor's liability." Restatement (Second) of Torts § 920A(2) (1979).[5]

b. In addition to erroneously interpreting the rules governing damages in securities cases, the court of appeals' decision is wrong as a matter of tax law. The court concluded (Pet. App. 10a) that the tax benefits

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[5] The court of appeals erroneously distinguished the collateral source rule on the ground that the tax benefits "emanate directly from the tax shelter * * * provided by [respondents]" (Pet. App. 13a). The tax benefits were in fact provided, however, by the Internal Revenue Code, not by respondents. In this respect, they constitute "benefits conferred * * * from other sources" within the meaning of Section 920A(2) of the Restatement.

claimed by petitioners on their 1977-1981 tax returns "represent[ed] an important tangible economic advantage" stemming from their limited partnership investments. Unless petitioners' damage recovery were diminished to reflect that fact, the court reasoned, the result "would be to confer an undeserved windfall upon [them]" (*id.* at 13a-14a). In thus reasoning, however, the court completely ignored the tax consequences of the damage recovery itself (*id.* at 14a). Depending on the facts involved, the tax consequences of a damage recovery *undiminished by tax benefits* would largely if not totally offset the tax benefits previously claimed. In short, because the Internal Revenue Code incorporates mechanisms for preventing "undeserved windfalls" to taxpayers in such circumstances, the court of appeals' "tax offset" theory is unnecessary and unjustifiable. Compare *Hanover Shoe, Inc.* v. *United Shoe Mach. Corp.*, 392 U.S. 481, 502-503 (1968) (award for lost profits based on pre-tax earnings where award is taxable), with *Norfolk & W. Ry.* v. *Liepelt*, 444 U.S. 490 (1980) (award for lost income based on after-tax earnings where award is not taxable).

The anticipated "tax benefits" stemming from a real estate tax shelter principally include losses that pass through from the partnership to the partners and become available as deductions against otherwise taxable income on their individual returns. Such losses also serve to reduce, dollar for dollar, the partner's cost, or tax "basis," of his investment. In addition to such tax shelter benefits, as in any investment that has proved to be poor or fraudulent, a partner may have claimed further tax deductions on disposing of his interest. For example, if he has been forced to sell his interest at a loss, as were petitioners here, he may have deducted that loss as a capital loss. See I.R.C. §§ 165, 741. Alternatively, a defrauded partner, while nominally main-

taining his investment, may have concluded that it has become worthless and deducted it, *e.g.*, as a theft loss. See I.R.C. § 165(c)(3), (e); see generally *Freschi* v. *Grand Coal Venture, supra.*

If the taxpayer subsequently obtains a recovery in a securities fraud suit, the effect of that recovery under the Internal Revenue Code may be to eliminate or offset, in whole or in part, the "tax benefits" described above. The precise manner in which this offset will be accomplished depends on a host of variables—how much time has elapsed since the taxpayer claimed his deductions, whether his tax returns are being audited by the IRS, what steps he has previously taken with respect to his investment, and what kind of recovery he obtains in the securities action. Under any scenario, however, the tax laws will require the partner to settle his accounts with the IRS—once all the facts surrounding his unhappy investment are finally determined—so as to eliminate the possibility of his garnering any "undeserved windfall."

If the tax years in which the deductions were claimed have not been closed by the statute of limitations, but remain subject to audit,[6] the IRS may disallow some or all of those deductions. For example, should the tax-

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[6] Generally speaking, a tax year "closes" three years after the return for that year is filed (I.R.C. § 6501(a)). However, a taxpayer and the IRS by agreement may extend the statute of limitations (*id.* § 6501(c)(4)), and this course is often followed in complex audits. In this case, petitioners claimed the relevant deductions on their tax returns for 1977-1981. At the time they commenced this lawsuit—August 1982—their 1979-1981 tax years would have remained open under the general three-year statute of limitations; the record does not reveal whether extension agreements were executed for 1977 and 1978. In certain situations, the IRS has more than three years in which to assess tax deficiencies. See I.R.C. § 6501(c) and (e). The record similarly does not reveal whether any of these exceptions might apply here.

payer win rescission of his investment contract, the IRS, depending on the circumstances, might disallow certain deductions predicated on his ownership of it. Alternatively, if the taxpayer has written off his investment entirely, that loss deduction may be disallowed on audit, depending, *e.g.*, on the type of loss claimed (loss on a sale, theft loss, or worthless securities), the time when the fraud was discovered, and whether the taxpayer was pursuing a claim for reimbursement with "a reasonable prospect of recovery" during the tax year in question. See Treas. Reg. §§ 1.165-1(d).

On the other hand, if the partner's earlier tax years are closed, other tax principles may apply to require adjustments that eliminate the benefit of the deductions he previously claimed. For example, if the defrauded partner wins relief in the nature of rescission, some if not all of his recovery could be taxed to him as ordinary income under the "tax-benefit rule." As this Court recently observed, the tax benefit rule operates to "cancel out an earlier deduction" when a subsequent event is "fundamentally inconsistent with the premise on which the deduction was initially based." *Hillsboro Nat'l Bank* v. *Commissioner*, 460 U.S. 370, 383 (1983) (original quotation marks and footnote omitted). Alternatively, if the defrauded partner wins out-of-pocket damages (see note 8, *infra*), the damage award generally will serve to reduce the basis of his partnership interest. If he has already disposed of that interest, or if he has reduced his basis to zero by previously-claimed deductions, the entire damage award will represent taxable income when received. Such an award might be taxed, in whole or in part, as ordinary income under the tax-benefit rule, or under the Code's various "recapture" provisions. *E.g.*, I.R.C. §§ 47 (investment tax credits), 1250 (depreciation). Any portion not so taxed would be taxed at capital gains rates. Compare *Raytheon Produc-*

tion Corp. v. *Commissioner*, 144 F.2d 110 (1st Cir.), cert. denied, 323 U.S. 779 (1944), with *Unvert* v. *Commissioner*, 656 F.2d 483 (9th Cir. 1981), cert. denied, 456 U.S. 961 (1982).

The above discussion is not intended as an exhaustive catalogue of tax consequences, which can be extremely complex and take years to resolve. The point is simply that the Internal Revenue Code, left to its own devices, will prevent the "undeserved windfall" about which the court of appeals was concerned. If a defendant has defrauded a plaintiff, the damages should be measured by the plaintiff's loss *on his investment*. The tax ramifications of the award are a matter between the plaintiff and the IRS. Once the securities lawsuit is over, and the relevant facts are finally determined, those ramifications will be sorted out, on a case-by-case basis, under well-established tax principles.

3. In insisting upon an immediate offset of previously-claimed tax benefits, the court of appeals has opted for an impractical and inequitable result that will have a significant adverse impact on administration of the federal securities and tax laws. Just last Term, the Court emphasized once again that "private actions provide 'a most effective weapon in the enforcement' of the securities laws and are 'a necessary supplement to Commission action.' " *Bateman Eichler, Hill Richards, Inc.* v. *Berner*, No. 84-679 (June 11, 1985), slip op. 10 (quoting *J.I. Case Co.* v. *Borak*, 377 U.S. 426, 432 (1964)). By improperly reducing—and often, as here, eliminating entirely—the damages recoverable by plaintiffs who have been defrauded in connection with tax shelter schemes, the rule applied by the court of appeals will necessarily lessen the incentives for promoters to comply with the securities laws and will permit those persons who have violated the laws to retain the fruits of their illegal activities.

From a tax perspective, the decision below is equally troubling. It will often happen, at the commencement of a securities action, that the tax returns on which the plaintiff claimed his deductions will be under audit by the IRS. In such circumstances, obviously, the plaintiff's "tax benefits" will be wholly speculative, and any effort to offset the damage award thereby will lapse into a tailspin of circular reasoning.[7] Most significantly, the court of appeals' tax-offset rule "make[s] the government the banker for fraudulent tax shelter activity" (*Burgess*, 727 F.2d at 838). By requiring a lower damage award—or none at all—for the plaintiff, the court of appeals' approach in turn will limit any possible recovery by the IRS when the award's tax consequences are taken into account. There is no reason in equity why a defendant's liability for his fraud should thus be diminished at the expense of his victims, or at the expense of taxpayers generally.

4. The instant case would provide an appropriate vehicle for the Court to address the question presented. In our view, it would also be appropriate for the Court to

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[7] It is no answer to suggest, as the Eighth Circuit has done, that "[e]vidence of the audit and expert opinions as to its likely result" should be introduced at trial, with "[t]he jury [being] entitled to determine whether and to what extent there would be a disallowance of deductions." *Austin* v. *Loftsgaarden*, 675 F.2d 168, 183 (1982), adhered to, *Austin* v. *Loftsgaarden*, 768 F.2d 949 (1985), petition for cert. pending *sub nom. Randall* v. *Loftsgaarden*, No. 85-519. The prospect of juries guessing about the outcome of complicated tax audits, often involving numerous taxpayers and difficult legal as well as factual questions, is altogether impractical. Nor is it any answer to demand, as the court of appeals did here, that the IRS speed up its audit procedures "rather than attempt to place the issue in limbo indefinitely" (Pet. App. 15a-16a). The difficulties attending audits of tax shelters, which may have thousands of partners or other investors spread across the country, are formidable, and recently prompted detailed remedial legislation by Congress. See Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, Tit. IV, § 402(a), 96 Stat. 648-669 (enacting I.R.C. §§ 6221-6232).

give plenary consideration to *Randall* v. *Loftsgaarden*, No. 85-519. In *Loftsgaarden*, plaintiffs sought damages under Section 12(2) of the Securities Act of 1933, 15 U.S.C. 77*l*(2), as well as under Section 10(b) of the Securities Exchange Act of 1934, the provision at issue here (see 768 F.2d at 952; 675 F.2d at 172, 180-184). While in our view the tax-offset rule is erroneous under either section, Section 12(2)'s damages provision—mandating recovery of "the consideration paid for [the] security * * * less the amount of any income received"—is worded differently from the "actual damages" limitation applicable to actions under Section 10(b). See page 6 & note 4, *supra*. Moreover, in *Loftsgaarden* the court of appeals acknowledged the relevance of the tax consequences of the judgment, but it set forth arbitrary rules for determining precisely how to measure the extent of tax benefits that must be offset (768 F.2d at 957-961). This issue was not addressed in the instant case because the court did not consider the tax consequences of any judgment material and the parties had stipulated that the tax benefits would exceed damages recoverable under a tax-offset regime (see note 1, *supra*). Accordingly, we believe that the Court would be able to consider more fully the complex issues presented in securities actions involving tax shelters if certiorari were granted in *Loftsgaarden*.[8]

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[8] The petition in *Freschi* v. *Grand Coal Venture*, No. 85-377, presents the question of the propriety of the tax-offset rule in the context of out-of-pocket damages (which are based on the difference between the price paid for a security and its actual value at the time of the purchase) rather than, as here and in *Loftsgaarden*, in the context of rescissionary damages (which "seek [ ] to restore the parties to the status quo ante the sale," *Garnatz* v. *Stifel, Nicolaus & Co.*, 559 F.2d 1357, 1361 (8th Cir. 1977), cert. denied, 435 U.S. 951 (1978)). In our view, the tax-offset rule is incorrect under either measure of damages. The court of appeals in *Freschi*

CONCLUSION

The petition for a writ of certiorari should be granted.
Respectfully submitted.

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also erroneously extended the tax-offset rule beyond the benefits provided by a tax shelter to tax deductions claimed by investors for losses suffered on routine disposition of investment assets. That reasoning obviously would extend the offset rule well beyond the tax-shelter context to computation of damage awards in all securities transactions. Should the Court wish to address these issues directly, it would be appropriate to grant the petition in *Freschi*, as well as granting the petition in *Loftsgaarden*.

We are providing copies of this brief to counsel in *Freschi* and *Loftsgaarden*.